SEEKING SOLUTIONS TO THE CRISIS OF THE EURO

The evolution of the European single currency is still uncertain. While the enlargement of the Euro Club continues, there is a likelihood that members facing systemic difficulties may have to leave it.

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Terms like “crisis”, “tragedy”, “failure”, “disintegration”, “risk of explosion”, have been used to exhaustion on the current situation of the euro (see, for example, the recent references by Paul Krugman in his chronicles on *The New York Times*). Although those who were always skeptical about the European monetary union are especially active, many of those who supported the process from its onset are now joining the group. Thus, we should stop for a while and reflect on what is really going on with the euro. Although this is a complex issue, we are going to try to analyze it as simply and directly as possible – and, therefore, along its main lines only.

Before anything else, let us not forget that the evolution of the euro is not as linear as it seems at first sight. Suffice it to recall that the Euro Club continues to increase in relation to its first 11 members – the latest country to join it, Estonia, was the 17th member, which just adopted the new currency on January 2011. The euro has also been one of the currencies that has appreciated the most against the dollar in recent years. Actually, the abandonment of Bretton Woods has caused wide and recurrent exchange rate fluctuations since the 1970s. But, comparing to 2001 (the eve of its entry into circulation), near the double of dollars are today necessary to obtain the same quantity of euros. In spite of this apparent contradiction, a process that enlarges and strengthens simultaneously, *the crisis is there* right in front of us, thus becoming necessary to consider its actual contours and reasons.

It is important to stress that, when the euro was launched in 1999 following a long preparation (mainly through the Treaty on European Union in 1992 and the Stability and Growth Pact in 1997), the requirements that were crucial to its feasibility – or at least for its existence without big shocks – were not clearly established in terms of the implications on the economic policy. Maybe there was not the willingness to regulate the process excessively, by expecting that Member-States themselves would do it at a certain point (through the criteria of nominal convergence). In any case, the issue concerning the role to be played by each entity participating in the process (European Council, national governments, European Central Bank), was not definitely solved, in particular for situations in violation of the most likely framework. As a consequence, the impact of the international crisis that started in 2007 just made it come to the surface.

It should be noted that one of the fundamental conditions for the existence of a monetary union is a consensus on the public finance policy (in particular, as regards deficit and debt). Although the nominal convergence criteria looked clear from this viewpoint – deficit limits lower than 3% of GDP, and public debt limits lower than 60% of GDP –, the reality was different. Thus, Europe is now divided between North and South, and each one of its parties tends to follow quite different ideas on how to handle fiscal issues (both from the spending and public revenues perspectives).

Germany and other Northern European countries, sometimes even those that are not members of the Euro Zone – like Denmark and Sweden, which seem to fear the "tolerant" or permissive members from the South –, currently follow a strict policy line. It is true that Germany, which has no excuse for its bad example, relaxed its commitment to a policy of fiscal rigor in the 1990s (which was an essential legacy from the first post-war decades). But its return to these principles, regardless of probable failures to manage the process, must be seen as a positive factor for the European Union, in general, and for the euro area, in particular.

Meanwhile, Portugal followed the opposite path. Suffice it to recall, for example, that one of the most publicly repeated sentences in the middle of the first decade of this century was "there is life beyond deficit". This is a clear appeal – consciously or unconsciously, it does not matter – to fiscal negligence. Besides, creating consensus is essential for any international agreement to be operational (and not only for the monetary union) and, contrary to what is mistakenly thought in Portugal, this issue should not be seen under the prism of political colors. Thus, for example, the social-democrat Minister of Finance Peer Steinbrük, from the then coalition government of Chancellor Angela Merkel, was one of the political officials who most firmly opposed the monetary recklessness to handle the financial crisis late in 2008 – a policy that would later enable Germany to reap benefits.

Still, as regards the problem of the sovereign debt, which is one of the most "exuberant" aspects of the crisis that currently affects several Member-States, it is important to recall Robert Mundell's approach. He won a Nobel Prize in Economics in 1999 and was explicitly recognized by the Nobel Committee for its contribution to the creation of the euro. Mundell has good knowledge on this subject, which he studied deeply. However, contrary to many politicians involved in the European process who underestimated the issue, the Canadian economist always gave much importance to the public debt limits. He even considered that the Treaty on European Union should have been more restrictive in this criterion – for example, by decreasing the maximum limit agreed by all to lower levels. The crisis and the developments along the recent years showed that Mundell was right.

The chart included in this article shows the large variety of situations that coexist within the euro area, and also highlights how some small economies rightly managed not to fall into the trap of a high public debt. Furthermore, in some cases, it is not only a matter of an excessive public debt. Other situations, not less serious, occur with the private debt, namely that of the financial system which is often incurred outside. The origin of these problems may be different, but its accumulation actually creates high-risk situations for the countries in question.

A significant number of European politicians, mainly in Portugal, have advocated that the solution for the current euro crisis is by quickly moving towards the fiscal federalism (where surplus countries would finance deficit countries, albeit under certain conditions). The obvious question is how can we move in that direction, if no previous minimum consensus exists regarding the policies to follow in the area of public finances.

Northern European politicians, and naturally the populations that elect them, are not quite willing to approve policies over which they have little or no control and, in our opinion, do not even want to have control over them. They consider that the responsibility for those policies lies with each Member-State (in accordance with the American president Thomas Jefferson, an advocate of federalism, its essence is by nature decentralized and the center should not be expected to interfere in any and every situation). Thus, we have to recognize that such moves would require much tighter controls, *generally applied and managed by the States in question*, than those that already exist, which would reduce the politicians' margin of maneuver (in terms of electoral "promises" and the actual demand to "tell the truth"). Are politicians and populations from one side and the other prepared to accept that? The answer to this question is fundamental, since fiscal federalism without well-defined principles would open the door to a logic of "moral hazard", further reinforcing the tendency for bad management and the decrease of "welfarism" on the part of those States that do not participate in the consensus or just pretend to participate, as the current situation already shows. From that perspective, the pathetic appeal for a "union of Southern countries", recently made by some Portuguese politicians, is a real disaster.

But we can say that, whether they are right or wrong, insufficient or not, frameworks for public finances in the Euro Zone still exist. Nevertheless, other imbalances, whose potential for rupture is even more serious in a monetary union, were kept in the shadow. Francesco Giavazzi, an Italian professor at the Universidade Bocconi in Milan and a visiting professor at the MIT, stresses the fact that some countries, by being confident of the single currency, neither prepared themselves in terms of competition (in a potential context of a "strong" currency, so to speak) nor made the structural reforms that are necessary for such process. The results can be seen: chronic high deficit in the current account and spiking debt vis-à-vis foreign countries (many European banks, from the "North" as well, got involved in this process, also believing that they would not take risks), a phenomenon that naturally got worse with the crisis. Well, the frameworks of the European monetary union do not include provisions on the foreign position – mainly as regards continued foreign imbalances –, which does not particularly give incentive to Member-States, individually considered, to become competitive. This issue applies of course to any country, whether it is or not in the euro area.

Items that are omitted, such as those we just referred to, do not escape naturally to the financial markets. And, as expected, they are even avidly exploited by them as a profitable business, which they are – for example, the much higher interests paid by the Greek or Portuguese debts in comparison with those of the Egyptian or Pakistani debt.

Which are then the possible solutions for the situations that we just analyzed? Taking into account that the process to create a robust international consensus is slow, can anything be done to help conjuncturally the countries which are most affected by the current crisis? It is obvious that the Euro Zone (through the European Council and the

ECB) could make a bigger effort to find conjunctural solutions for the crises that are declared, as it happened at the time of the European Monetary System, while new frameworks made necessary by the crisis are established. However, the enlargement itself of the euro area and the diversity of the existing conditions hamper such type of solutions, not to mention the tendency to concentrate the financing costs in some countries and entities.

If we take into account all these assumptions, the evolution of the single European currency continues to be uncertain under some aspects, namely as regards the probable exit of some members that show systemic difficulties in the monetary integration. Still according to Franceso Giavazzi, an alternative for exiting the monetary union might be the adoption of a code for Member-States to declare bankruptcy – "*Sovereign Bankrupty Code*" – when that would be the case (leading to similar programs, albeit possibly harsher, of those already currently in place in Greece, Ireland and Portugal). However, such situation may bring about more difficulties in political management. In any case, even if some members exit the Euro Zone, the world that Milton Friedman dreamed of in 1953 (external adjustments would occur "spontaneously" through automatisms created by a general regime of freely floating exchange rates), would not be the ideal solution either for a process like globalization – much less for very integrated economic spaces, due to the degree of uncertainty and unpredictability that it carries. Besides, this belief only brought about more troubles and arbitrariness to a sector that is decisive in the international economic relations, as the current "currency exchange wars" show, instead of working as a stimulus for the general good. On the other hand, voices such as that of the North-American and former IMF consultant Barry Eichengreen admit as a possibility a relatively reduced number of monetary areas, controlled by certain currencies, at the international scale. Thus, there is not a big margin for choices.

To wrap-up, whatever the solutions that may be found for the current euro crisis in the short or long term, and unless globalization and regionalization slowdown to a great extent, it is convenient to recall John Stuart Mill, a 19th century economist and a firm advocate of freedom: "So much barbarism still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own convenience and that of their neighbors, a peculiar currency of their own". A lesson learned from the current crisis is that for a State to participate in a monetary union, or at least to accept the rules of a more or less deep and intense international monetary harmonization, and take advantage of that, it is indispensable that that State establishes a large internal macroeconomic discipline. And, consequently, that it safely handles the main leverages of the economic policy.

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